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Public Service Commission of Wisconsin
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BEFORE THE
PUBLIC SERVICE COMMISSION OF WISCONSIN

Joint Application of Wisconsin Electric Power Company and Wisconsin Gas Company, both d/b/a We Energies, for Wisconsin Electric Power Company to Increase Its Electric, Natural Gas, and Steam Rates and for Wisconsin Gas Company to Increase Its Natural Gas Rates

Docket No. 05-UR-102

INITIAL BRIEF OF THE CITIZENS UTILITY BOARD

The Citizens Utility Board ("CUB") hereby files its initial brief in the above-captioned matter. By order dated August 17, 2005, the Public Service Commission ("PSC" or "Commission") awarded CUB intervenor compensation to advocate on certain issues arising from the request of Wisconsin Electric Power Company ("WEPCO" or the "Company") to raise its rates effective January 1, 2006, including: 1) WEPCO's earnings cap proposal; 2) Synergy savings associated with the merger of Wisconsin Energy Corporation ("WEC") with WICOR; 3) the impact of the company's deferrals and requested carrying charges; 4) the allocation of power, transmission and distribution costs in cost of service studies; and, 5) rate design. CUB addresses these and other issues below.

I. INTRODUCTION.

This summer, various WEC public utility affiliates filed to increase their rates effective January 1, 2006. (Tr. 1014.) As part of these submissions and in support of its electric operations, WEPCO filed for an increase of $143.6 million (6.9%). (*Id.*) Although the Company claimed its financial data indicated a revenue deficiency of $281.1 million, it sought roughly only half of this amount in increased rates. (*Id.*) The Company sought an increase for three specific items: $67.5 million related to American Transmission Company charges, $70.1 million related to Power the Future costs, and $6 million related to renewable sources of energy. (*Id*.) WEPCO assumed a 12.2% return on equity ("ROE") with its filing. (*Id*.) WEPCO also proposed an earnings cap mechanism to create a one-half percent bandwidth around its "midpoint" return on common equity of 12.2%. Under this mechanism, the Company could file for an increase in rates if it would earn less than 11.7%, and would apply earnings above 12.7% to its outstanding deferred account balances or as a credit on customer bills. (Tr. 55-57.)

Based on its initial audit, Staff estimated a $204.9 million revenue deficiency for WEPCO's electric operations. (Tr. 1015.) Later, Staff revised this revenue deficiency upwards to $269.8 million to reflect higher fuel costs as a result of Hurricanes Katrina and Rita. (Exs. 5 and 116, Sch. 1, page 2.) In response to the Commission staff testimony, WEPCO submitted a letter to the Commission acknowledging that the higher fuel costs "should be used in setting rates for 2006 and for monitoring fuel costs during 2006." (Ex. 5.) Rather than seeking a $143.6 million rate increase, WEPCO was now asking for a $228 million increase, $84 million above WEPCO's original request. (Tr. 1266.) Staff's audit reduced this $84 million amount and instead reflected an additional $64,981,000 in increased fuel costs. (*Id*.)

In its letter concerning its higher fuel costs, the Company also stated that it would refund any fuel costs collected in 2006 in excess of monitored fuel costs actually incurred with interest set at its short-term debt rate. (Ex. 5.) At hearing, WEPCO clarified that this offer meant that it would refund such revenues even if the Company had not exceeded the fuel monitoring bandwidth. (Tr. 33-34.) The refund would only apply if WEPCO had received a fuel cost increase during the test year and its earnings exceeded 12.7%, the top end of its proposed earnings cap bandwidth. (Tr. 37-38.)

II. THE COMMISSION SHOULD REJECT THE COMPANY'S PROPOSED EARNINGS CAP PROPOSAL IN FAVOR OF SERIOUS EFFORTS TO REDUCE THE AMOUNT OF THE COMPANY'S OUTSTANDING DEFERRALS.

WEPCO has proposed an earnings cap mechanism in which it would be allowed to seek rate increases if its ROE would fall below 11.7% or to apply earnings in excess of 12.7% to its outstanding deferrals or as a credit on customer bills. The Commission should reject the request because it does not offer adequate ratepayer benefits. If the Commission decides to adopt WEPCO's earnings cap proposal, it should first modify it by disallowing certain costs and rejecting the Company's proposed capital structure and ROE levels. In the alternative, the Commission should adopt CUB's earnings cap proposal to apply any excess earnings above the Company's ROE to WEPCO's outstanding deferrals.

A. The Company's Earnings Cap Proposal Does Not Offer Adequate Ratepayer Benefits.

The Company touts its earnings cap proposal as "asymmetric in a way that benefits customers" because WEPCO would give up the right to seek a rate case in the event it shows a shortfall of 50 basis points or less on its ROE. (Tr. 60.) But this purported ratepayer benefit is illusory. As CUB witness Lee Smith points out, the Company's entire return component is only 11% of its revenue requirement. Thus, a shortfall of 50 basis points or less on its ROE would translate to a revenue deficiency of less than .6%, making it unlikely that the Company would even bother filing a rate case for such a relatively small amount. (Tr. 848, 861.) Moreover, permitting the Company to over-earn up to an ROE of 12.7% would allow it to pocket a $6 million premium with no corresponding ratepayer benefit for this sum. (Tr. 815.)

The Company's proposal also comes with an important and objectionable string attached. WEPCO is adamant that under its earnings cap proposal it should be allowed to recover in rates for items that the Commission typically disallows such as management incentives, sales promotion and non-statutory advertising. (Tr. 58-61, 1030.) If WEPCO recovers in rates the costs of these traditionally disallowed items, it will artificially lower its earnings for purposes of determining whether it has earned in excess of allowed earnings under its earnings cap proposal. (Tr. 1040.) WEPCO makes no apologies for this outcome. Despite the transparency of this manipulation, the Company has said it will withdraw its earnings cap proposal if the Commission gives effect to Staff's disallowances. (Tr. 61.) The Commission should not countenance any proposal that would require it to ignore standard disallowances.

Lastly, the mechanics of the earnings band are not clear nor do they ease this Commission's oversight responsibilities. Having prepared no written documents or analyses on this important issue, the Company seemed uncertain how its own earnings cap proposal would operate. (Tr. 81-82.) First, the Company testified that it would examine its earnings after the calendar year closed to determine if it had excess earnings that could be applied to outstanding deferrals. (Tr. 56.) But later, at hearing, the Company changed its position and asserted that this determination could be done prior to the end of the test year. (Tr. 84-85.) These mid-year rate cases could also work the other way in that the Company could apply mid-year for a rate increase if it could demonstrate that it would not earn up to the lowest level of its proposed earnings band. (Tr. 71-72.) The prospect of mid-year rate filings, in addition to fuel rate cases, hardly eases this Commission's regulatory burdens. The Commission has enough rate cases without opening the door to more.

B. In Conjunction With Its Review Of The Earnings Cap Proposals, The Commission Should Reject The Company's Proposed ROE Levels And Capital Structure.

The Company has proposed that its earnings cap proposal be centered upon a 12.2% ROE and that only earnings above 12.7% would trigger an obligation to apply such over-earnings to deferred amounts. The Commission should reject such high returns in light of the evidence suggesting such ROE levels are excessive and unfair to ratepayers. The Commission should likewise reject the Company's call to increase the amount of equity in its capital structure as inadequately justified in the record and as no more than an effort to dilute its earnings to avoid over-earning under its earnings cap proposal.

The evidence in this proceeding in favor of lower ROE levels is substantial. Offering lengthy and detailed analytical testimony, Commission staff member Steve Kihm proposed an ROE for the Company of 10.5% to 10.9% with Commission staff calculating the Company's revenue deficiency based on a 10.9% ROE. (Tr. 1015-16, 1081.) Mr. Kihm's suggested range, offered he said for pragmatic reasons, is actually higher than the 8% equity ranges he believes would reflect the cost of equity for utilities today. (Tr. 1081.) Commission staff suggested that if the ROE is set at 10.9%, the Company's proposed earnings cap range of 11.7% to 12.7% could be adjusted to 10.4% to 11.4%. (Tr. 1028.) Likewise applying standard financial models, WIEG witness Michael Gorman estimated that WEPCO's current cost of common equity to be no more than 10.5%. (Tr. 942.) Mr. Gorman further suggested with this ROE, the Company's proposed earnings cap range should be 10% to 11%. (Tr. 942-43.)

This Commission can take a positive step towards ensuring fairness to ratepayers by rejecting the Company's proposed ROE. First, the Company's proposal is not in tune with regulatory decisions from around the country. Nationally, ROE levels for utilities have fallen from an average of 10.73% for 2004 to 10.3% in the second quarter of 2005. (Tr. 950.) Moreover, lowering WEPCO's ROE from 12.2% to 10.7% reduces the Company's revenue requirement by roughly $68 million, very nearly the amount of increased fuel costs reflected in Staff's audit for the test year. (Tr. 1141, Ex. 5.) In light of this Commission's recent decision permitting WEPCO to retain its excess revenues under the fuel rules,[1] the Commission can send an important signal that it seeks to balance the interests of the Company, its shareholders and ratepayers by rejecting the Company's requested ROE levels in favor of returns more in keeping with the national average for utilities, an outcome consistent with the analysis and testimony of Messrs. Gorman and Kihm. CUB agrees with WIEG's suggested 10.5% ROE and, if the Commission accepts WEPCO's earnings cap mechanism, WIEG's proposed bandwidth of 10% to 11%.

The Company has also asked to increase its average financial equity share of its capital structure to 54.3% with a range of 52.3% to 56.3%, higher than its previously authorized range of 48.5% to 53.5%. (Tr. 50-51.) The Commission should reject the Company's proposal for two reasons. First, increasing equity levels effectively dilutes earnings, making it more difficult for the Company to exceed its earnings cap. Second, the Company has not demonstrated a net ratepayer benefit resulting from increasing the equity amounts. As this Commission well knows, equity is more expensive than debt, all other things being equal. WEPCO's parent holding company, WEC, has a BBB+ rating. (Tr. 63.) With its proposal to increase its equity levels, the Company seeks a strong A to AA rating. (Tr. 50.) The Company, however, simply has not shown that raising its equity levels will improve its credit rating in the face of the already lower credit rating of its parent holding company, and that even if it did accomplish this goal, the benefit to ratepayers is greater than the additional cost.

[1] Amended Findings of Fact, Conclusions of Law, and Final Order, p. 8, Docket No. 6630-UR-111 (November 23, 2005).

C. To Address The Large Size Of The Company's Deferrals, CUB Proposes To Apply Over-Earnings Not Associated With Fuel Rule Recovery To Outstanding Deferral Balances And For The Company To File A Plan Regarding Reducing Its Deferrals.

In this proceeding, CUB has offered an alternative to the Company's earnings cap proposal. Under CUB's plan, the Commission would order the Company to apply its over-earnings not associated with fuel rule increases to its outstanding deferrals. The primary difference between the CUB and WEPCO proposals is that CUB would not allow WEPCO to over-earn up to a certain percentage before the Company was required to apply its over-earnings to outstanding deferrals. Additionally, CUB urges the Commission to require WEPCO to prepare and file a plan concerning how it will reduce its outstanding deferral balances, including the use of write-offs. (Tr. 813, 1030-31.)

CUB is unaware of any state regulatory commission that has ordered the adoption of a plan similar to CUB's proposal. Then again, WEPCO is also unaware of any earnings cap mechanism exactly like what it has proposed in this proceeding. (Tr. 76.) CUB makes its proposal because of concern regarding the large and growing amount of deferred accounts on WEPCO's books. In a presentation to the Company's Board of Directors, WEPCO's auditors stated that the Company's Regulated Assets Net of Liabilities had increased by $454 million from December 31, 2000 to September 30, 2004, and that the Company faced a potential increase of $338 million over the next three years. (Tr. 812.) These are large amounts of money that, CUB submits, the Commission cannot ignore. Compounding the concern, the Company is not proposing to reduce its estimated 2005 year-end transmission and PTF deferral balances and plans to defer other cost increases for certain escrowed items for future ratemaking. (Tr. 18-19.) By its own admission, the Company itself lacks a plan to address deferrals after 2007. (Tr. 813.)

At hearing, WEPCO asserted that CUB's proposal constitutes retroactive ratemaking. (Tr. 61.) However, CUB is merely suggesting that excess earnings be applied to expenses for which the Commission has already approved deferred accounting. CUB sees little distinction between the Company collecting in rates amounts sufficient to pay amortized expenses associated with a deferral as opposed to using excess earnings to accomplish the same result. In essence, CUB is proposing that the Commission condition WEPCO's proposed rate increase upon the Company "refunding" its excess earnings similar to the mechanics of the fuel rule. *See* Wis. Admin. Code § PSC 116.07(6).

As deferrals grow, so do the risks for both the Company and its customers. (Tr. 813-14.) Some day, as the expression goes, the chickens must come home to roost. Moreover, delay in cost recovery makes it more difficult for intervenors to challenge the prudency of the costs that had been deferred. (*Id*.) The Company may no longer employ key witnesses, or memories of events may fade. The Commission should adopt CUB's proposal as a means of addressing WEPCO's large and growing deferral account balances. Additionally, the Commission should require the Company to file a plan concerning how it will reduce its deferrals. (Tr. 813.) The plan should address, among other issues, the appropriateness of writing off deferrals when the recovery period is too long under accrual accounting principles and Commission policy. (Tr. 1031.)

D. Applying Excess Earnings To Deferrals Should Be Done Only After Intervenors Have Been Afforded The Opportunity To Challenge The Appropriateness of Rate Recovery For Those Deferred Costs.

Irrespective of whether the Commission adopts WEPCO's or CUB's earnings cap proposals, it should ensure that intervenors are afforded an opportunity to challenge the prudency of the deferred costs before WEPCO applies its over-earnings to these deferrals. The Company has said it would let the Commission decide on the type of process it would use in this regard but has indicated its willingness to file a notice with the Commission of any plan to apply over-earnings and further said it would stipulate to an order point requiring that the notice be served upon intervenors. (Tr. 74-75.) The Company also said that it would have no objection to the Commission affording parties an opportunity to object to the prudency of the deferred costs for which the Company has indicated in its notice that it intends to apply its over-earnings. (Tr. 75.) Commission staff testified that this was an important concession because otherwise the Commission might not ever have a chance to determine if recovery of certain costs was reasonable. (Tr. 1029.)

Thus, if either WEPCO's or CUB's earnings cap proposal is adopted, the Commission should order WEPCO to file with the Commission, with service upon intervenors, a notice that it will apply over-earnings to certain deferrals. At a minimum, the Commission should require that the notice detail the type and amount of the cost deferred and that it identify the Commission's original order approving deferred accounting for the cost. The Commission should also afford intervenors and interested persons an adequate opportunity to challenge the prudency of those costs in a contested case proceeding. It should further provide that, in the event that the Commission would determine that the costs were incurred imprudently, the PSC would require WEPCO to apply its over-earnings to other deferrals, or if all other deferrals had been addressed, to give ratepayers an appropriate bill credit. (Tr. 74.)

III. THE COMMISSION SHOULD SET PTF ESCROW CARRYING COSTS AT THE COMPANY'S SHORT-TERM DEBT RATE.

Undaunted by its previous failures to convince the Commission, the Company again requests that its carrying costs for the Power the Future escrow be set at the long-term overall weighted cost of capital. (Tr. 810.) The Commission should again deny the request.

Despite the Company's claims, the PTF escrow is not a long-term asset of the company. WEPCO projects that PTF escrow account totals will fluctuate in 2006 and 2007. (Tr. 811.) At times, over the next two years, the escrow balance will in fact go substantially negative during some of this period, which hardly suggests this escrow is like a long-term asset. (*Id*.) Additionally, as a matter of policy, the Commission should send a signal to the Company that it does not want it to treat deferred accounts as long-term investments. Setting the carrying costs at the Company's short-term debt rate provides WEPCO with an incentive to seek timely collection during the rate-making process. (*Id*.) Finally, the difference to the Company's revenue requirement between using the two levels of carrying costs is not insignificant, ranging from roughly $2 to $3 million annually. (Tr. 812.) The Company has not demonstrated a ratepayer benefit that would justify granting its request for increasing its carrying costs.

IV. THE COMMISSION SHOULD LOWER THE COMPANY'S REVENUE REQUIREMENT FOR CERTAIN ITEMS ASSOCIATED WITH SYNERGY SAVINGS FROM THE WEC-WICOR MERGER.

As a condition of its approval of the WEC's acquisition of WICOR, Inc., the Commission required WEPCO to abide by a five-year rate restriction period effective January 1, 2001. Final Decision at 3, *Application of Wisconsin Energy Corporation for Approval to Acquire the Stock of WICOR, Inc.*, Docket Nos. 9401-YO-100 and 9402-YO-101 (March 15, 2000), hereinafter, "the Merger Order." The Commission permitted WEPCO to retain the synergy savings resulting from the merger for five years, but denied cost recovery for transaction costs and any unrecovered acquisition premium. Merger Order at 3 and 5. The Commission further stated that at the end of the five-year rate restriction period, WEPCO would be free to make its best case regarding the appropriateness of more synergy savings retention. Merger Order at 9. WEPCO has not asked to retain its synergy savings.

For purposes of this proceeding, CUB witness Lee Smith reviewed whether the Company had adequately reflected its synergy savings in the Company's revenue requirement and whether it had appropriately written off all of the costs incurred to effectuate the WEC-WICOR merger. (Tr. 829.) In the course of that review, she determined that total non-gas supply synergy savings, less implementation costs through 2005, totaled $223.9 million. (Tr. 830.) Ms. Smith also recommended two adjustments to the Company's books for purposes of calculating earnings. First, because WEPCO sold the Metro South Service Center in 2005 as a result of the merger, the Company should reduce its rate base by the net book value of the plant effective immediately. (*Id*.) WEPCO did not dispute this adjustment. Second, at the end of 2005 the Company's books will still reflect $8.4 million of costs to achieve the merger, costs which would be depreciated throughout the test year. (*Id*.) Permitting the Company to include in its revenue requirement these depreciation expenses as an offset against earnings is, in effect, a backdoor way of letting it retain synergy savings beyond those already retained during the initial five-year period. The Company has already netted substantial benefits from the WEC-WICOR merger. As a matter of equity, it is simply asking too much of ratepayers to foot the bill for the costs to achieve the merger in light of the windfall the Company received under the WEC-WICOR merger. Moreover, failure to write off the $8.4 million amount in 2005 will result in overstating the Company's expenses and therefore interfere with a proper determination of whether the Company has over-earned in 2006 or 2007. Indeed, Commission staff witness Tom Ferris agrees that these adjustments should be made for "coming up with the return earned under an earnings cap plan." (Tr. 1069.) Therefore, the Commission should provide customers with the full benefits of the synergy savings going forward and require that WEPCO remove any remaining costs to achieve the merger from its revenue requirement to determine its future earnings.

V. THE COMMISSION SHOULD REDUCE THE COMPANY'S REVENUE REQUIREMENT TO REFLECT A REASONABLE LEVEL OF ASSUMED FORCED OUTAGES AT THE OAK CREEK AND PLEASANT PRAIRIE PLANTS.

On behalf of CUB, Ms. Smith testified that WEPCO's modeling overstated its projected 2006 fuel costs due to an inordinate level of assumed starts and stops at the Oak Creek and the Pleasant Prairie generating facilities. As Ms. Smith noted, if WEPCO's PROSYM model projects more stops for these units than are likely to actually occur, it will overstate costs. This is especially crucial for the Oak Creek and Pleasant Prairie units because they are among the Company's lowest priced units, and they have relatively long start-up times. (Tr. 831.)

Specifically, WEPCO projected its fuel costs under the PROSYM model assuming 35 starts for the two Pleasant Prairie units and a large number of starts for its Oak Creek units. (Tr. 832.) In response to CUB data requests, the Company produced PROSYM model runs in which the Pleasant Prairie units had six starts each, resulting in a fuel cost reduction of $3.2 million, and a roughly $500,000 reduction associated with fewer starts at the Oak Creek units. (*Id.*) CUB was justified in insisting that WEPCO model these lower start totals. The Pleasant Prairie units had only four starts between them in 2004 and 15 in 2005. The 2005 number of starts was higher than normal because the Company had instituted what it called "coal conservation" that resulted in the coal units stopping more frequently than would otherwise occur. (*Id.*) Tracking the Company's responses to CUB's data requests on this subject, Commission staff reduced the Company's revenue requirement by $3.7 million accordingly. (Tr. 974-75.)

Ms. Smith testified in surrebuttal that a subsequent rerun of the PROSYM model reflecting six starts in total for both the Pleasant Prairie units—more in keeping with a normal level of outages—demonstrated a cost reduction of $3.5 million. (Tr. 854-55.) In addition, she testified that even this $3.5 million plus the $.5 million (Pleasant Prairie and Oak Creek) reduction in WEPCO's revenue requirement was too low in light of higher gas prices not yet reflected in the Company's modeling. In response, the Company again ran its PROYSM model assuming 6 starts and stops at the Pleasant Prairie units but with no reduction to the stops and starts at Oak Creek.[2] (Tr. 1244.) The resulting savings was $3.7 million from the Pleasant Prairie units alone. (Tr. 789.) Overall savings amounted to $4.2 million, with Oak Creek savings still reflecting the original lower gas prices. (*Id*.) Ms. Smith indicated that this new PROSYM run might still understate the impact of a normal level of outages because of when the smaller number of outages occurred in the model. (Tr. 1246-47.)

In light of these developments, Mr. Wagner of Commission staff recommended that the Company should rerun the model with not only updated gas costs but also reflecting Commission decisions on a number of model inputs, presumably including the correct number of outages to model for the Pleasant Prairie and Oak Creek units. (Tr. 984.) CUB supports Staff's recommendation but believes that the Commission should insist that Staff determine that the Company's PROSYM run reflects a normal distribution of outages before accepting it. (Tr. 1248-49.)

VI. CONSISTENT WITH THE AGREEMENT OF CUB AND WEPCO, THE COMMISSION SHOULD ORDER WEPCO TO WORK WITH COMMISSION STAFF TO DEVELOP MEASURES OF SUCCESS FOR ITS RENEWABLES EXPENDITURES.

WEPCO proposes to spend an additional $6 million in the test year for renewable projects. (Tr. 19.) While CUB supports the development of renewable energy, it is important to ensure accountability for the Company's expenditures in this regard. To this end, in response to

[2] The greater the price of gas, the greater is the cost of replacement power when the Pleasant Prairie and Oak Creek units are down. Thus, reducing the number of stops and starts at these plants reduces the amount of replacement power costs, producing larger savings when gas prices are higher.

questions from CUB at hearing, the Company agreed to accept an order point directing it to work with Commission staff to develop measurable goals for its new renewable programs. (Tr. 107.) The Company also stated it would accept an order point that it would work with Commission staff to select an independent third party evaluator who would determine whether the Company had met its goals. (Tr. 107-08.) The Company would pay for the evaluator using a portion of the $6 million requested for the test year. (Tr. 107.)

Based on the Company's agreement and consistent with sound public policy, the Commission should adopt the proposed order point as described above.

VII. THE COSS PREPARED FOR THIS PROCEEDING SUBSEQUENT TO WEPCO'S REVISION OF ITS RATE CASE SUGGEST RESIDENTIAL CUSTOMERS SHOULD RECEIVE NO MORE THAN AN AVERAGE RATE INCREASE.

As noted above, WEPCO initially filed for an increase of $143,645,000 for its electric operations. (Tr. 1266.) It later increased this request by $84,046,000, with Staff recognizing only an additional $64,981,000 increase due to an adjustment it made concerning treatment of certain purchased power costs. (*Id*.) In response to this development, WEPCO was asked to run three COSS—one each based on the preferred methodologies of WEPCO, CUB and WIEG—assuming a total revenue requirement of $2,361,491,000 and a 12.9% rate increase of $269,835,000, an amount that incorporated Staff's audited fuel cost total. (Tr. 1265.) The results indicated that small use customers should receive a near average increase while General Primary customers should receive a "much larger than average increase." (Tr. 1266, Ex. 116, Sch. 1, page 1.)

In setting rates, however, the Company proposes a lower percentage rate increase than 12.9% because it does not seek to fully recover for its revenue requirement. Accordingly, taking into account higher fuel costs, WEPCO anticipated increasing rates for the residential class by 10%, an increase above its originally proposed 6.7% amount. (Ex. 116, Sch. 2, page 1.)

A. Although Better Than The COSS Of Other Wisconsin Utilities, WEPCO'S COSS Methods Could Be Improved.

WEPCO's COSS were an improvement over those put forward by other Wisconsin utilities. WEPCO applied the equivalent peaker method to its production costs resulting in a 62% demand/38% energy allocation mix, although CUB disputes the accuracy of WEPCO's application of the method. (Tr. 1261-62.) The Company also weighted energy use to reflect on-peak and off-peak differences in cost, and adjusted for interruptible load in a manner consistent with Commission staff's normal method. (Tr. 1262.) Although the Company used a minimum distribution system method to allocate its distribution costs, it determined that only 8.7% of overhead line plant costs and 2.2% of underground line costs were assigned using customer allocators. (*Id.*) Notwithstanding these positive qualities, CUB submits that the Company's COSS methods can be improved.

1. CUB differs with the Company in its allocation of production power costs.

For the reasons stated below, CUB disagrees with the Company's application of the equivalent peaker method and its allocation of purchased power capacity and maintenance expenses.

a. CUB offered a corrected version of the equivalent peaker method.

The equivalent peaker method correctly recognizes a "capitalized" energy component to baseload and intermediate-sized plants because these plants are built not just to meet demand but to make available cheaper sources of energy. However, in applying the equivalent peaker method, the Company compared the original book value of its peaking units with the original book value of its other generating plant, making no adjustment for the fact that its baseload and intermediate coal units are significantly older than its newer peaking plants. (Tr. 852.) Thus, its computation was biased by the age of generating plant. The Company's application of the equivalent peaker method is inconsistent with its description in the NARUC Manual. (*Id*.) The NARUC Manual states that the cost analyst should compare different types of technology based on comparable prices, that is, the cost of new units. Ms. Smith's computation of the equivalent peaker method demonstrated that if the Company's plant is priced consistently as if new, 65% is energy related. (Tr. 818.) While the Company disputed CUB's understanding of the equivalent peaker method, it did not dispute the accuracy of the 65% calculation once CUB's assumptions are accepted. In spite of this result, Ms. Smith recognized that this calculation was not exact, and recommended that a simple 60/40 energy/demand split be used to allocate existing generation plant. (Tr. 819.)

b. Purchased power capacity costs and maintenance expenses should be partly allocated on energy and not just on demand.

The Company classified $258 million of production expense as demand-related, including all purchased power capacity costs and significant portions of its production operation and maintenance expense. Ms. Smith testified that these allocations do not reflect cost causation and instead determined that of this $258 million, only a total of $32 to $50 million of expenses was caused more by demand than energy. (Tr. 820.)

After reviewing WEPCO's purchased power costs, including the Whitewater and Ameren System contracts, Ms. Smith testified that the Company incurred many of its purchased power capacity costs to reduce energy costs, and the allocation of these types of contracts should be on the basis of energy, not demand. (Tr. 819.) No party disputed her conclusions. Regarding operation and maintenance expenses, Ms. Smith testified "most of the expenses in these accounts will vary with the amount of energy produced . . . ." (Tr. 820.) No party disputed the fact that most of the operation and maintenance expenses that the Company had allocated on the basis of demand were in fact energy related.

2. CUB recognizes that 10% of transmission investment should be allocated on the basis of energy and not just demand and further suggests that the Commission order WEPCO to engage in additional study in this regard.

The record demonstrates that some portion of WEPCO's transmission costs should be allocated on the basis of energy. The record shows that some transmission investment has been incurred in order to move lower cost power and therefore to save energy costs. For instance, high voltage transmission lines are built to transmit power from nuclear power plants to load centers. (Tr. 825.) Just as it is appropriate to allocate a portion of the nuclear power plant on energy, rather than just demand, so too is it appropriate to allocate a portion of the transmission line serving the plant to energy as well. Allocating some portion of the transmission system on energy also better reflects cost causation. Larger energy users reap more benefits than smaller energy users from the existence of transmission that reduces energy costs. (Tr. 827.)

WEPCO, on the other hand, allocated all of its transmission expense on the basis of demand. Most of WEPCO's transmission costs are incurred in the form of charges from MISO. (Tr. 825.) MISO bills WEPCO on both a demand and energy basis. (Tr. 827.) Thus, WEPCO's allocation of transmission costs solely on demand does not reflect how MISO bills for transmission, since "currently 7% of MISO/ATC costs are billed on the basis of energy." (*Id.*) In light of this evidence, CUB recommended conservatively that 10% of WEPCO's transmission costs should be allocated on energy. CUB further recommended that before the Company's next base rate proceeding, it should conduct an analysis of the fundamental cost causation basis for all of its transmission costs and report on its findings.

3. The Commission should discount results of COSS that use a minimum distribution system as the basis for customer class revenue allocations.

The Company allocated distribution costs through use of the Minimum Distribution System ("MDS") method. Under MDS, the analyst estimates the cost of a distribution system required to serve the minimal use of each customer. (Tr. 821-22.) The size of this hypothetical system is said to vary by the number of customers, and under this assumed relationship, can be allocated by the number of customers and thus recovered as a customer charge. (Tr. 822.) The remainder of the distribution system above the minimum is allocated on demand. (*Id.*)

CUB disputes the use of MDS. Ms. Smith argued that the Company does not invest in distribution poles, lines, and transformers because of the number of customers, but rather because of anticipated customer load and therefore revenues.

> The importance of demand in causing cost can be evidenced by considering how incremental distribution investments are made. If load increases on a circuit, even if there is no increase in the number of customers, it is often necessary to install a more expensive conductor that can carry more load. By contrast, if the number of customers on a circuit increases, but there is no increase in load, it would not be necessary to install more poles, conductors, or transformers.

(Tr. 823.) She also observed that utilities simply would not construct distribution for minimum loads. (Tr. 845.) Utilities' unwillingness to do so is evidenced in line extension policies that relate the amount of plant the utility will install (without a customer contribution) to the expected load or revenue from the customer. (*Id.*)

To be sure, WEPCO's implementation of MDS was more reasonable than many utilities' methodologies because it was clearly intended to estimate minimum cost. (Tr. 822.) As noted above, the Company determined that only 8.7% of overhead line plant costs and 2.2% of underground line were costs assigned using customer allocators. (Tr. 1262.) Nonetheless, the

Company's allocation of a portion of its poles, conductors and transformers as customer-related should be rejected.

B. The Customer Class Revenue Allocation Resulting From CUB's COSS Suggests That Residential Classes Should Receive No Higher Than The Average Percentage Rate Increase.

The Company ran its cost of service model to reflect the allocation changes recommended by Ms. Smith. Prior to the audited fuel costs increasing the Company's total rate request, Ms. Smith demonstrated that the residential class deficiency was 11% less than what WEPCO claimed. (Tr. 829.) The COSS results conducted after WEPCO increased its rate request due to higher fuel costs likewise shows that small use customers should receive less of a percentage increase in rates than shown by WEPCO's COSS with the reverse being true for industrial customers. Ms. Smith's analysis strongly supports the conclusion that residential customer classes should receive no higher than the average percentage rate increase.

VIII. THE COMMISSION SHOULD ACCEPT CUB'S RATE DESIGN PROPOSALS.

CUB has long maintained that electric rates should be designed to send appropriate price signals that promote energy efficiency. Increased fixed monthly charges do not reward the customer taking steps to become more energy efficient or to participate in load management programs. Those charges remain constant no matter if a customer has willingly switched to compact fluorescent bulbs or installed more efficient air conditioning. To this end, and for reasons of equity, CUB opposes aspects of the Company's rate designs that increase residential customer charges, and suggests alternatives.

A. CUB Opposes More Than A 10% Increase In The Residential Customer Charge.

With its original filing, WEPCO proposed to increase the customer charge from 17% to 18% for the residential customer classes. (Tr. 835.) For reasons of fairness and to provide better price signals, the Commission should limit the residential customer charge increase to no more than 10%.

The Company described its customer charge increase as a step towards establishing the same customer and energy charges for all residential and general secondary non-demand metered rate schedules. (Tr. 833.) The Company hoped that this change would avoid controversy over "whether a particular customer is on the appropriate rate." (Tr. 834.) The Commission should reject this approach because it will result in a still higher future increase in the residential customer charge. The meter cost for General Secondary Flat rate customers is $83.19 while the cost of meters for residential flat rate customers is $40. (*Id.*) Collapsing these customer classes together will inevitably result in residential customers paying more in fixed customer charges than are justified by the cost of serving them because meter costs for these combined classes will be based on an average cost derived from the cost of more expensive meters that residential customers will not use.

Additionally, CUB supports limiting the fixed residential customer charge increase to 10% and instead increasing the energy charge on residential customers to make up for the lost revenues, provided such charges are set consistent with appropriate COSS results.[3] (Tr. 858.) Raising fixed customer charges reduces the incentives to pursue energy efficiency. (Tr. 836.) Moreover, increasing the fixed monthly customer charge is regressive to the extent that lower income customers use less energy than persons who have greater incomes. (*Id*.)

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[3] CUB had initially proposed recovering the lost revenue from lowering the customer charge by raising energy prices on industrial customers. CUB withdraws that aspect of this proposal in favor of recovering the costs from the residential customer class, provided that recovery is consistent with appropriate COSS results.

B. Instituting A Summer/Winter Differential In Energy Prices May Be Appropriate.

CUB recommends that the Commission order the Company to study and report on whether instituting a summer/winter differential in energy prices is appropriate. (Tr. 836-37.) Differentiating the cost of energy between summer and winter may better reflect cost-causation and send better price signals concerning the value of energy efficiency and load curtailment during energy-expensive times of the year.

IX. SUMMARY OF REQUESTED ORDER POINTS.

The following is a summary of CUB's requested order points as discussed above:

Earnings Cap/Deferrals

- WEPCO shall apply its earnings above its authorized return on common equity to outstanding deferrals. Before so applying its over-earnings, it shall file a notice with the Commission and serve same on intervenors in this proceeding. The notice should detail the type and amount of the cost deferred and the Commission's original order approving deferred accounting for the cost. Intervenors will have 15 days to object to the proposed application of over-earnings. Upon receipt of such an objection, the Commission shall set the matter for a contested case hearing. In the event the Commission rules against applying over-earnings to a particular deferral, the Company will write off the deferral.

- WEPCO's return on common equity is set to be no more than 10.5%.

- WEPCO's authorized financial equity range is set at between 48.5% and 53.5%.

- WEPCO shall file a plan indicating how it will reduce the balances of its outstanding deferrals.

- Carrying charges for WEPCO's PTF escrow account shall be set at the Company's short-term debt rate.

Synergy Savings

- WEPCO shall remove from its books the Metro South Service Center and any remaining costs to achieve synergy savings for purposes of determining the Company's revenue requirement and earnings level.

Fuel Costs

- WEPCO shall rerun its PROSYM model to reflect the decisions made by the Commission during its discussion of the record in this proceeding, including inputting into the model no more than 6 outages for WEPCO's Pleasant Prairie generation units and the number of outages for WEPCO's Oak Creek generation units as modeled for CUB and accepted by Staff in its audit of the Company's 2006 fuel costs.

Renewables

- WEPCO shall work with Commission staff to develop measurable goals for its renewable programs for which the Company has asked for a $6 million increase and to select an independent third party evaluator who would determine whether the Company had met its goals. The evaluator shall be paid from the $6 million increase.

Cost of Service/Customer Class Revenue Allocation

- CUB's COSS shows that the residential customer classes should receive no higher than the average percentage rate increase.

- WEPCO shall study and report on the causes of its transmission costs and analyze what portion of those costs should be allocated on demand and energy.

Rate Design

- WEPCO shall establish and maintain separate customer charges for residential and general secondary non-demand metered rate schedules.

- WEPCO shall limit its residential customer charge increase to 10%.

- WEPCO shall study and report on whether instituting a summer/winter differential in energy prices is appropriate.

X. CONCLUSION.

For the aforementioned reasons, CUB requests that the Commission adopt the Order points set forth above.

Dated this 28th day of November, 2005.

Respectfully submitted,

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By: ________________________________

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